

UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

JAMES JOHNSON, individually and on  
behalf of all others similarly situated,  
PHIL CHEN, and FRED D. DAVOLI,

Plaintiffs,

v.

COSTCO WHOLESALE  
CORPORATION, W. CRAIG JELINEK,  
and RICHARD A. GALANTI,

Defendants.

C18-1611 TSZ

ORDER

THIS MATTER comes before the Court on the Motion of Defendants Costco Wholesale Corporation (“Costco”), W. Craig Jelinek (“Jelinek”), and Richard A. Galanti (“Galanti”) (collectively, “Defendants”) to dismiss Plaintiffs’ Second Amended Complaint<sup>1</sup> for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6), docket no. 44. Having reviewed all papers filed in support of and in opposition to the motion, the Court enters the following order.

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<sup>1</sup> Plaintiffs filed a Second Amended Complaint, docket no. 38, and a subsequent corrected version, docket no. 41. Reference in this Order to the Second Amended Complaint refers to the corrected version at docket no. 41.

## **Background**

By Order dated November 26, 2019, docket no. 37, the Court dismissed without prejudice Plaintiffs' Consolidated Amended Complaint alleging claims for securities fraud against Defendants. In doing so, the Court found that the Plaintiffs' alleged false statements<sup>2</sup> were not actionable misrepresentations because the Plaintiffs had not alleged scienter for any of the alleged misrepresentations. Order, docket no. 37 at 44. The analysis and reasoning of the Court's Order is incorporated by reference and will not be repeated. Because the parties are familiar with the facts and regulatory scheme that govern this case, they are not recited here in great detail.

Plaintiffs subsequently filed a Second Amended Complaint ("SAC")<sup>3</sup> that adds new allegations from some of the previously pled confidential witnesses<sup>4</sup> ("CWs") 1 and 6 as well as a new confidential witness, CW 8.<sup>5</sup> The Second Amended Complaint realleges violations of the Securities Exchange Act of 1934 ("Exchange Act") and Rule

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<sup>2</sup> The Consolidated Amended Complaint alleged six false and misleading statements. Consolidated Amended Complaint, docket no. 26. Statements 1-4 as alleged in the Consolidated Amended Complaint relate to statements made in connection with Costco's June 6, 2018 10-Q. Statements 5 and 6 were made in the Form 8-K, filed on October 4, 2018, and during the earnings call that same day. Of those statements, only statements 1-3 are realleged in the Second Amended Complaint. Plaintiffs do not reallege statements 4-6 in the Consolidated Amended Complaint. Statement 4 was Defendants' statement in the June 6, 2018 10-Q that there were "no material changes" in the risk factors from the 2017 annual report and that Costco was "currently making" and would continue to make significant technology investments. Consolidated Amended Complaint, docket no. 26 at ¶ 159. Plaintiffs have abandoned any reliance on statements Defendants made in October 2018.

<sup>3</sup> Plaintiffs have now filed four complaints: the original Complaint (docket no. 1), the Consolidated Amended Complaint (docket no. 26), the Second Amended Complaint (docket no. 38), and the corrected Second Amended Complaint (docket no. 41).

<sup>4</sup> With the exception of the addition of CW 8, the CW numbering in the Consolidated Amended Complaint and the Second Amended Complaint is the same.

<sup>5</sup> The Court previously ascribed little to no weight to CWs 2, 3, and 4, finding that their testimony was vague, inconsistent, or that they did not work at Costco during the class period. Order, docket no. 37 at 12-15, 20. Plaintiffs have failed to cure those deficiencies in the Second Amended Complaint.

1 10b-5 against all Defendants and violations of Section 20(a) of the Exchange Act against  
2 the individual Defendants on behalf of themselves and a putative class of shareholders  
3 who acquired Costco stock during the period from June 7, 2018 to October 25, 2018 (“the  
4 class period”) and were damaged (the putative class). SAC ¶¶ 20, 300. Plaintiffs now  
5 allege that the June 6, 2018 10-Q and Defendants Jelinek’s and Galanti’s accompanying  
6 certifications of that filing were false and misleading because they stated that the  
7 company had effective internal controls in place in the 2018 Fiscal Year. *Id.* at ¶¶ 241-  
8 47.

9 The parties acknowledge that the only issue for the Court to decide on the present  
10 Motion to Dismiss is whether Defendants’ allegedly false and misleading statements in  
11 June 2018 assuring investors that Costco’s internal controls were “effective” and that  
12 Costco was fully compliant with the Sarbanes-Oxley Act of 2002 (“SOX”) were made  
13 with the requisite scienter. Defendants’ Motion to Dismiss, docket no. 44 at 12-13;  
14 Plaintiffs’ Opposition, docket no. 45 at 7. The Court therefore now turns to whether  
15 Plaintiffs’ new allegations—either alone or holistically—support the requisite strong  
16 inference of scienter.

17 **A. Alleged Failure to Remediate User Administration and Access Control Issues**

18 In the Second Amended Complaint, Plaintiffs present one additional confidential  
19 witness, CW 8, who was employed by Costco as an architectural employee in the IT  
20 department throughout the Class Period and who worked 2-3 levels below the Chief  
21 Information Officer, (“CIO”). SAC ¶ 39. CW 8 alleges that, in 2014, Costco had a  
22 strategy on authentication and authorization that would have remediated user  
23 administration and access control issues. *Id.* at ¶ 182. That plan was approved by the

CIO, Paul Moulton, “and received by all the VPs and SVPs that were a part of the office of the CIO.” *Id.* at ¶ 183. Plaintiffs allege that CIO Moulton reported directly to Defendant Galanti. *Id.* at ¶ 28. CW 8 alleges that Costco ultimately did not implement the recommended remediation plan because, according to one IT director, “there was no budget,” “it was not a priority,” and that “there were more important things to work on.” *Id.* at ¶ 184. CW 8 alleges that if Costco had implemented the plan in 2014 (at an alleged cost of about \$10 million), “the SOX findings would have come back clean.”<sup>6</sup> *Id.*<sup>7</sup>

#### **B. Alleged IT Risk Management Disbanded**

Plaintiffs also add new allegations from CW 1 that Defendants were “aware” that Costco’s IT Risk Management department was disbanded in the middle of 2017. *Id.* at ¶¶ 13, 148. CW 8 contends that the IT Risk Management department “never settled on a specific framework.” *Id.* at ¶ 150. CW 8 also contends that the IT Risk Management department disbanded because it was disorganized and not well managed. *Id.* Plaintiffs allege that Tim Bowersock, the VP of Information Security, knew that the IT Risk Management department had been disbanded and that the Board was making it a “mission” to cut headcount and costs in the IT department in 2018. *Id.* at ¶ 192.

Defendant Jelinek was responsible for reviewing and approving the IT budget. *Id.* at ¶ 253 Plaintiffs allege that former employees stated that management viewed security and

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<sup>6</sup> CW 8 also alleges the failure to implement a tool in 2015 that would have helped maintain Costco’s internal controls related to user administration. SAC ¶ 185.

<sup>7</sup> Plaintiffs also add allegations from CWs 1 and 8 regarding the sufficiency of Costco’s internal controls, generally. *See* SAC ¶¶ 164–66, 172–73. Because the Court already concluded that Plaintiffs adequately alleged that Costco’s internal controls were insufficient (Order, docket no. 37 at 35), and because the parties agree that the only issue to be resolved on this Motion is scienter, the Court does not incorporate these new generalized allegations into the analysis of this Order.

1 internal controls as an “afterthought” or a “necessary evil.” *Id.* Plaintiffs also add new  
2 testimony from CW 6 that in early 2018, “there was a six-month period where the  
3 department lacked a centralized team overseeing” the internal risk registry. *Id.* at ¶ 151.

#### 4 **C. Alleged Emails from Defendant Jelinek Regarding SOX Compliance**

5 Plaintiffs also add new allegations from unidentified former employees that in  
6 early 2017, Defendant Jelinek sent a series of internal emails urging those at the company  
7 to “button up” internal controls and prioritize SOX compliance issues but “gave up  
8 despite knowledge of actual SOX compliance issues.” *Id.* at ¶¶ 12, 159.

#### 9 **D. Other Allegations**

10 Plaintiffs also state a variety of general, non-specific allegations relating to “red  
11 flags” in the company: (1) that Costco’s e-commerce expansion put “additional strain” on  
12 Costco’s already underfunded and understaffed IT department (SAC ¶¶ 2, 7, 13, 57–58,  
13 134, 269); (2) that Costco settled claims and was developing a system of internal controls  
14 and procedures related to a variety of areas unrelated to a material weakness in internal  
15 control over financial reporting including opioid prescriptions, embezzlement, and  
16 product safety (*id.* at ¶¶ 10, 112–17, 261–63);<sup>8</sup> and (3) a lengthy description of the COSO  
17 framework (*id.* at ¶¶ 83–94, 103–07). Plaintiffs’ attempt to describe these events as “red  
18 flags” does not make it so.

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21 <sup>8</sup> Some of these allegations relate to events well outside the class period, and it is unclear how they bear  
22 on Defendants’ state of mind as of June 2018. For example, the Department of Justice settlement related  
23 to improperly filled prescriptions occurred on January 19, 2017. SAC ¶ 113. The embezzlement by a  
former employee occurred from 2011 to 2016. *Id.* at ¶ 115.

## 1 Discussion

### 2 **A. Legal Standards<sup>9</sup>**

#### 3 **i. Motion to Dismiss**

4 Although a complaint challenged by a Rule 12(b)(6) motion to dismiss need not  
 5 provide detailed factual allegations, it must offer “more than labels and conclusions” and  
 6 contain more than a “formulaic recitation of the elements of a cause of action.” *Bell Atl.*  
 7 *Corp. v. Twombly*, 550 U.S. 544, 555 (2007). The complaint must indicate more than  
 8 mere speculation of a right to relief. *Id.* When a complaint fails to adequately state a  
 9 claim, such deficiency should be “exposed at the point of minimum expenditure of time  
 10 and money by the parties and the court.” *Id.* at 558. A complaint may be lacking for one  
 11 of two reasons: (i) absence of a cognizable legal theory, or (ii) insufficient facts under a  
 12 cognizable legal claim. *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 534 (9th  
 13 Cir. 1984). In ruling on a motion to dismiss, the Court must assume the truth of the  
 14 plaintiff’s allegations and draw all reasonable inferences in the plaintiff’s favor. *Usher v.*  
 15 *City of Los Angeles*, 828 F.2d 556, 561 (9th Cir. 1987). The question for the Court is  
 16 whether the facts in the Second Amended Complaint sufficiently state a “plausible”  
 17 ground for relief. *Twombly*, 550 U.S. at 570. If the Court dismisses the Second

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 20 <sup>9</sup> Defendants request that the Court take judicial notice of Exhibits 2–7 to the Declaration of John C.  
 21 Roberts Jr. in Support of Motion to Dismiss Consolidated Amended Complaint, docket no. 28. These  
 22 documents include selected SEC filings and guidance, and the Court previously found the documents  
 23 incorporated by reference into the Consolidated Amended Complaint. Order, docket no. 37 at 26-27. The  
 Court again takes judicial notice of Exhibits 2-7. They are referenced in the Second Amended  
 Complaint, are matters of public record, their authenticity is not in dispute, and Plaintiffs do not oppose  
 the request.

1 Amended Complaint or portions thereof, it must consider whether to grant leave to  
2 amend. *Lopez v. Smith*, 203 F.3d 1122, 1130 (9th Cir. 2000).

3 **ii. Pleading Standard Under the Securities Exchange Act of 1934 and**  
4 **the Private Securities Litigation Reform Act (“PSLRA”)**

5 Section 10(b) of the Exchange Act makes it unlawful for any person to “use or  
6 employ, in connection with the purchase or sale of any security . . . any manipulative or  
7 deceptive device or contrivance[.]” 15 U.S.C. § 78j(b). SEC Rule 10b–5 imposes  
8 liability on any person who “make[s] any untrue statement of a material fact” or “omit[s]  
9 to state a material fact necessary in order to make the statements made, in light of the  
10 circumstances in which they were made, not misleading.” 17 C.F.R. § 240.10b–5(b).

11 To state a Section 10(b) claim, a plaintiff must allege: (1) a material misstatement  
12 or omission by the defendant; (2) scienter; (3) a connection between the material  
13 misrepresentation and the purchase or sale of a security; (4) reliance upon the  
14 misrepresentation or omission; (5) economic loss; and (6) loss causation. *Halliburton*  
15 *Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 267 (2014).

16 Under the PSLRA, Section 10(b) claims must be pled with particularity. *In re*  
17 *Quality Sys., Inc. Sec. Litig.*, 865 F.3d 1130, 1140 (9th Cir. 2017). The PSLRA heightens  
18 the particularity required but does not convert a motion to dismiss into a trial by papers.  
19 *In re LDK Solar Sec. Litig.*, 584 F. Supp. 2d 1230, 1260 (N.D. Cal. 2008); *see also*  
20 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322 (2007) (even in PSLRA  
21 cases, courts must accept all factual allegations in the complaint as true). Further, courts  
22 are cautioned against allowing heightened pleading standards to make it “near  
23

impossible” to state a fraud claim. *Khoja v. Orexigen Therapeutics, Inc.*, 899 F.3d 988, 999 (9th Cir. 2018).

Scienter is the “mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Under the PSLRA, the complaint must plead a “strong inference” that defendants<sup>10</sup> acted intentionally or with deliberate recklessness. “Reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care.” *S.E.C. v. Platforms Wireless Int’l Corp.*, 617 F.3d 1072, 1093 (9th Cir. 2010) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990)). “[D]eliberate recklessness” that “reflects some degree of intentional or conscious misconduct” is necessary to plead scienter. *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1051 (9th Cir. 2011), *abrogated on other grounds by Lorenzo v. SEC*, 139 S. Ct. 1094 (2019). In determining whether a

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<sup>10</sup> Plaintiffs contend that Costco’s Chief Information Officer, Moulton, received a report recommending that Costco install a program to remediate user and access control issues. Plaintiffs state that because Moulton received and approved the report but failed to correct the individual Defendants’ alleged misrepresentations regarding a material weakness in internal controls, this Court should infer “corporate scienter” on a collective scienter theory. Plaintiffs’ Opposition, docket no. 45 at 25. Citing *In re Volkswagen “Clean Diesel” Mktg., Sales Practices, & Prods. Liab. Litig.*, 2017 WL 6041723, at \*9 (N.D. Cal. Dec. 6, 2017), Plaintiffs assert that scienter of a corporation may be pled by establishing the knowledge or deliberate recklessness of a corporate representative who either made the representation, had some involvement with the statements, or could have corrected it. Plaintiffs’ Opposition, docket no. 45 at 12-13. Plaintiffs misstate the law of this circuit regarding collective scienter and the holding of *In re Volkswagen*, in which the court found that while it is “possible” in theory to infer scienter on the basis of collective scienter, no Ninth Circuit court had ever apparently done so. 2017 WL 6041723, at \*11. Moreover, the example that Ninth Circuit courts have cited as a hypothetical case in which collective scienter may be appropriate because it “would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false” is “General Motors announc[ing] that it had sold one million SUVs in 2006, and the actual number was zero.” *Id.* at \*10-11; *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1063 & n.13. That example is completely inapposite to the facts of this case.



1 defendant acted with scienter, a court considers “opposing inferences” and “plausible,  
2 non-culpable explanations.” *Tellabs, Inc.*, 551 U.S. at 323-24. A complaint survives  
3 only if the culpable inference is “at least as compelling” as the nonculpable inference. *Id.*  
4 at 324.

5 When analyzing the sufficiency of a plaintiff’s scienter pleadings, a court must  
6 “determine whether any of the allegations, standing alone, are sufficient to create a strong  
7 inference of scienter.” *N.M. State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089,  
8 1095 (9th Cir. 2011). If no individual allegation is sufficient, the Court conducts a  
9 “‘holistic’ review of the same allegations to determine whether the insufficient  
10 allegations combine to create a strong inference of intentional conduct or deliberate  
11 recklessness.” *Id.* (quoting *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d at 991-92  
12 (9th Cir. 2009)).

13 Failure to satisfy the PSLRA’s heightened pleading standard requires dismissal of  
14 the complaint. 15 U.S.C. § 78u-4(b)(3)(A).

### 15 **B. Plaintiffs’ Allegations in Support of Scienter**

16 Plaintiffs assert that the following four bases support an inference of scienter: (1)  
17 confidential witness testimony of scienter; (2) Defendants shirked their oversight duties  
18 and ignored red flags regarding material weaknesses in internal controls; (3) Defendants  
19 each had access to information revealing material weaknesses in Costco’s internal  
20 controls yet did nothing; and (4) Defendants’ remedial measures to correct material  
21 weaknesses in internal controls. The Court addresses each basis.

**i. Plaintiffs' confidential witness testimony**

Plaintiffs contend that the testimony of CWs 1, 6, and 8<sup>11</sup> provides evidence sufficient to raise a strong inference of scienter. The new testimony in the Second Amended Complaint suffers from the same deficiencies as the previous complaint. Courts use a two-part test to determine if the alleged CW testimony supports scienter. First, the court determines whether the complaint describes each CW with "sufficient particularity to establish their reliability and personal knowledge." *Zucco Partners, LLC*, 552 F.3d at 995. Second, the CWs' statements "must themselves be indicative of scienter." *Id.*

Plaintiffs describe CWs 1, 6, and 8 with sufficient particularity to establish their personal knowledge as to their allegations regarding the state of the IT department (*see, e.g.* SAC ¶¶ 32, 37, 39 (describing CWs' job titles, tenure, and role in Costco's IT department)). Plaintiffs do not indicate, however, that CWs 1, 6, and 8 have reliable personal knowledge regarding what either Defendant Galanti or Jelinek knew regarding the material weakness in internal controls on June 6, 2018, when the alleged false statements were made.

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<sup>11</sup> Because Plaintiffs have not supplemented the testimony of CWs 2-5 and 7, the Court does not reanalyze the reliability of that testimony in this Order. The Court therefore still gives little weight to the testimony of CWs 2 and 4. Order, docket no. 37 at 19-20. The Court found that CW 2's and 4's statements were vague and inconsistent. *Id.* at 12-15. It is also still not clear whether CW 2 worked at Costco during the Class Period. The Court again lends no weight to the testimony of CW 3, who Plaintiffs still do not allege worked at Costco during the Class Period. The Court found that Plaintiffs described CWs 5 and 7 with sufficient particularity to establish their personal knowledge regarding the material weakness in Costco's internal controls. The parties stipulate that the existence of a material weakness is not at issue in this Motion.

1 As the Court previously found, CW 1 acquired his information through multiple  
2 degrees of separation, was part of the GDPR compliance, not financial controls section of  
3 the IT department, and had no way of verifying his beliefs regarding what Defendants  
4 Jelinek and Galanti knew at the time. Order, docket no. 37 at 38-40. None of the  
5 additional CW 1 allegations in the Second Amended Complaint remedy this deficiency.  
6 The only new allegation that connects the alleged material weakness in internal controls  
7 with what the individual Defendants knew is CW 1's allegation that Defendant Jelinek  
8 sent 4-5 companywide emails directing everyone to "do better at being SOX compliant."  
9 SAC ¶¶ 12, 159, 268. Such a broad, companywide directive does not indicate Defendant  
10 Jelinek's knowledge of a material weakness related to IT controls. CW 1's assertions  
11 that Defendant Jelinek failed to follow up or "gave up" on compliance are also purely  
12 conclusory, not based on any personal knowledge, and are not sufficiently particularized  
13 to support a "strong inference" of intent to deceive, manipulate, or defraud as is required  
14 under the PSLRA. 15 U.S.C. § 78u-4(b)(2)(A).

15 CW 6 heard about and witnessed others discussing what Defendant Jelinek said  
16 about the state of the IT department. CW 6 also discussed Galanti's reaction to an IT  
17 employee survey. The Court found these allegations insufficient to show personal  
18 knowledge of Defendants' scienter. Order, docket no. 37 at 40. The additional CW 6  
19 allegations in the Second Amended Complaint relate to an internal risk registry that was  
20 disbanded. SAC ¶ 151. Plaintiffs fail to explain how those additional allegations remedy  
21 the previous deficiencies with CW 6's lack of personal knowledge regarding Defendants'

1 scienter. *Zucco Partners, LLC*, 552 F.3d at 995; *Police Ret. Sys. v. Intuitive Surgical,*  
 2 *Inc.*, 759 F.3d 1051, 1063 (9th Cir. 2014).

3 Plaintiffs similarly do not allege that CW 8—the only new confidential witness—  
 4 had any direct contact with or reliable personal knowledge regarding what Defendants  
 5 Galanti and Jelinek knew at the time. CW 8’s allegations regarding what an unnamed  
 6 “IT director” told him about the IT budget (SAC ¶ 184), his “assumption” that Costco’s  
 7 board discussed change management (*id.* at ¶ 201), and that Defendant Jelinek ultimately  
 8 approved of what he believed was an underfunded IT budget (*id.* at ¶¶ 124-25, 190), are  
 9 not grounded in CW 8’s personal knowledge about what Defendants knew. Therefore,  
 10 while each of the CWs may be qualified to offer general testimony regarding the state of  
 11 the IT department (*id.* at ¶¶ 124-26, 190), general user access and change management  
 12 issues (*id.* at ¶¶ 163-66), the existence of IT risk management teams and systems (*id.* at  
 13 ¶¶ 150-51), or the failure to remedy certain user administration issues in 2014-2015 (*id.*  
 14 at ¶¶ 182-85, 203), no CW contends that Defendants Jelinek and Galanti knew but  
 15 disregarded such information.<sup>12</sup>

16 On their own, the Court concludes that each of Plaintiffs’ individual CWs do not  
 17 allege sufficient facts to support a claim of scienter. Similarly, considered holistically, the  
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 20 <sup>12</sup> Indeed, Plaintiffs’ contentions are to the contrary because they state that the buck stopped with middle  
 21 management. *See* SAC ¶¶ 126, 159, 206 (placing blame for IT department issues on VPs and “middle  
 22 management”). Also, to the extent Plaintiffs revitalize the argument that Costco intentionally defunded  
 23 its IT department, the Court previously rejected that argument due in part to the contradictory allegations  
 in the complaint. Order, docket no. 37 at 30 n.8. Moreover, the Court places little weight on new  
 allegations from CW 8 regarding the state of Costco’s IT department funding because it is unclear how a  
 lower level architectural employee in the IT department would have any reliable personal knowledge  
 regarding the adequacy of department funding.

facts alleged by the CWs are also insufficient to allege scienter. *Webb v. SolarCity Corp.*, 884 F.3d 844, 855 (9th Cir. 2018).<sup>13</sup>

**ii. Plaintiffs’ theory that Defendants shirked their oversight duties and ignored red flags regarding material weaknesses in Costco’s internal controls**

The bulk of Plaintiffs’ remaining new allegations amount to contentions that Defendants Jelinek and Galanti possessed the requisite scienter because they had a duty to know about and remedy various “red flags” in internal controls yet did not do so.<sup>14</sup> Plaintiffs’ Opposition, docket no. 45 at 3-4. The new allegations in support of this argument include that Costco’s e-commerce expansion put “additional strain” on Costco’s already underfunded and understaffed IT department (SAC ¶¶ 2, 7, 13, 57–58, 134, 269) and that Costco settled claims and was developing a system of internal controls and procedures related to a variety of areas including opioid prescriptions, embezzlement, and product safety (*id.* at ¶¶ 10, 112–17, 261–63). Plaintiffs also allege that an IT department risk management group that could have helped identify IT security threats was disbanded due to poor management. *Id.* at ¶¶ 148, 150-51.

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<sup>13</sup> Plaintiffs contend that a CW’s lack of personal knowledge of a defendant’s state of mind, reliance on hearsay, lack of contact with a defendant, several degrees of separation from a defendant, or employment solely outside the class period is not always fatal. Plaintiffs’ Opposition to Motion to Dismiss, docket no. 45 at 14-18. While it may be possible to show an inference of scienter even despite any one of those deficiencies, Plaintiffs have not done so here. None of the CWs support a strong inference of scienter because their testimony does not show that Defendants Jelinek and Galanti made the alleged misrepresentations with intentional recklessness. *WPP Luxembourg Gamma Three Sarl*, 655 F.3d at 1051, *abrogated on other grounds by Lorenzo v. SEC*, 139 S. Ct. 1094 (2019).

<sup>14</sup> Plaintiffs contend that Defendants “consciously deprived” the IT department of funding. Plaintiffs’ Opposition, docket no. 45 at 20-21 (citing SAC ¶¶ 121-59). None of the allegations, however, in the cited paragraphs of the Second Amended Complaint, support an inference of Defendants’ conscious intent.

1        These new allegations are unrelated to user control issues as they relate to  
 2 financial reporting. Even assuming allegations that Defendants breached some oversight  
 3 duty<sup>15</sup> set forth in the COSO framework, Section 10(b) and Rule 10b-5 do not protect  
 4 investors from mismanagement. Negligence alone is not sufficient to support a strong  
 5 inference of scienter. *See, e.g., Merck & Co. v. Reynolds*, 559 U.S. 633, 648-49 (2010)  
 6 (heightened standards for pleading scienter not satisfied where inference is defendant  
 7 acted “innocently or negligently”). Section 10(b) and Rule 10b-5 also do not protect  
 8 investors from fraud by hindsight. *In re Metawave Commc'ns Corp. Sec. Litig.*, 629 F.  
 9 Supp. 2d 1207, 1219 (W.D. Wash. 2009) (quoting *Ronconi v. Larkin*, 253 F.3d 423, 430  
 10 n.12 (9th Cir. 2001). Moreover, any contention that senior IT management’s decision to  
 11 disband the IT risk management group adequately alleges corporate scienter because IT  
 12 management could have corrected the alleged misrepresentations misconstrues the  
 13 general rule that scienter be pled with respect to the individuals who actually made the  
 14 false statements. *See supra* footnote 10; *Glazer Capital Mgmt. v. Magistri*, 549 F.3d 736,  
 15 745 (9th Cir. 2008).

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19 <sup>15</sup> Plaintiffs cite Costco’s COSO framework, which details Defendants’ required oversight activities for  
 20 SOX. SAC ¶¶ 251-254. Instead of Plaintiffs’ intended effect of revealing a breach of these duties,  
 21 however, Plaintiffs’ citation to this list of activities is a checklist of the deficiencies in Plaintiffs’ Second  
 22 Amended Complaint. Plaintiffs do not allege with particularity that Defendants failed to perform the list  
 23 of required oversight activities. In fact, some of Plaintiffs’ allegations appear to support Defendants’  
 compliance with the COSO framework’s oversight requirements. For example, the only new allegation in  
 the Second Amended Complaint that specifically refers to an action by an individual Defendant is the  
 email from Defendant Jelinek that stresses the importance of SOX compliance and internal controls. This  
 email is evidence of Defendant Jelinek’s good faith compliance with the COSO framework’s oversight  
 requirement that he “communicate direction and ‘tone at the top.’” SAC ¶¶ 159, 252.

1           **iii. Plaintiffs’ theory that Defendants each had access to information**  
2           **revealing material weaknesses in Costco’s internal controls yet did**  
3           **nothing**

4           Plaintiffs again allege that Defendants’ ability to access information showing a  
5           material weakness is sufficient to support a finding of scienter. This Court has already  
6           rejected Plaintiffs’ core operations argument. Plaintiffs must either allege that  
7           Defendants personally accessed the information showing a material weakness in internal  
8           controls, Order, docket no. 37 at 41-42 (citing *City of Dearborn Heights Act 345 Police*  
9           *& Fire Ret. Sys. v. Align Tech., Inc.*, 856 F.3d 605, 620 (9th Cir. 2017)), or that the falsity  
10          of the information was so “patently obvious” that it would be “absurd” to suggest that top  
11          management was unaware of them. Order, docket no. 37 at 42 (citing *Zucco Partners,*  
12          *LLC*, 552 F.3d at 1001 (quoting *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 989  
13          (9th Cir. 2008)). Hypothetical access or ability to access information, as Plaintiffs allege  
14          here, is not enough to satisfy scienter pleading requirements. *See, e.g., Police Ret. Sys.*,  
15          759 F.3d at 1062 (“Mere access to reports containing undisclosed [] data is insufficient to  
16          establish a strong inference of scienter”); *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027,  
17          1036 (9th Cir. 2002) (rejecting “conclusory” allegation that defendants had “access to”  
18          information).

19          Moreover, to the extent Plaintiffs contend that the Court should infer scienter as to  
20          Costco and the individual defendants by pleading scienter as to other corporate  
21          executives, that contention again relies on a scienter standard that is not the rule in this  
22          circuit. *See supra* footnote 10; *Glazer Capital Mgmt.*, 549 F.3d at 745 (9th Cir. 2008).

1           **iv. Plaintiffs’ theory that Costco’s remedial measures are evidence of**  
2           **scienter**

3           Plaintiffs also repeat the argument that the remedial measures Defendants  
4           undertook after disclosing the material weakness are themselves evidence of scienter.  
5           SAC ¶ 279-80. As the Court previously found, a company’s decision to enhance  
6           financial controls does not, on its own, show that Defendants knew about the extent of  
7           any previous material weakness. Order, docket no. 37 at 43 (citing *In re GlenFed, Inc.*  
8           *Sec. Litig.*, 42 F.3d 1541, 1553 (9th Cir. 1994) (“The fact that policies may change over  
9           time does not mean that an earlier policy was inadequate, or that statements regarding its  
10          adequacy were falsehoods.”)). The Court again must conclude that the remedial  
11          measures Defendants undertook after disclosing the material weakness—either alone or  
12          in conjunction with other allegations—are not evidence of Defendants’ scienter.

13           **C. More Plausible Inference**

14          In determining whether a defendant acted with scienter, a court considers  
15          “competing inferences” and “plausible, non-culpable explanations.” *Tellabs, Inc.*, 551  
16          U.S. at 323-24. A complaint survives only if the culpable inference is “at least as  
17          compelling” as the nonculpable inference. *Id.* at 324.

18          As before, the more plausible inference is that Defendants Jelinek and Galanti  
19          were unaware of any material weakness when they worked to prepare the quarterly report  
20          in June 2018 but became aware when they undertook the more labor-intensive task of  
21          preparing the annual report. Order, docket no. 37 at 45. Plaintiffs do not offer any  
22          explanation for why Defendants would have concealed a weakness in June 2018 only to  
23          disclose it a few months later, other than to state that Defendants should not be



1 “rewarded” for a belated discovery of a material weakness. Indeed, Plaintiffs do not  
2 allege that Defendants profited from the alleged fraud or were otherwise motivated to  
3 conceal information that they would later reveal.

4 The Court therefore concludes that none of Plaintiffs’ allegations “standing alone,  
5 are sufficient to create a strong inference of scienter.” *N.M. State Inv. Council*, 641 F.3d  
6 at 1095. Even considering all of Plaintiffs’ new allegations in combination with the  
7 allegations in the Second Amended Complaint, Plaintiffs at most paint a picture of  
8 mismanagement—not a strong inference of scienter. *Webb*, 884 F.3d at 855.

#### 9 **D. Dismissal with Prejudice<sup>16</sup>**

10 If the Court dismisses the complaint or portions thereof, it must consider whether  
11 to grant leave to amend. *Lopez*, 203 F.3d at 1130. Plaintiffs have had four opportunities  
12 to allege facts in support of their claims. *Supra* footnote 3. Most recently, despite the  
13 Court’s previous Order identifying the specific deficiencies, Plaintiffs have again failed  
14 to plead particularized allegations of fact supporting a strong inference of scienter. This  
15 latest attempt scrapes the proverbial bottom of the barrel, as Plaintiffs’ additional  
16 allegations contain little to no direct knowledge about the alleged misrepresentations  
17 contained in statements 1-3 as set forth in the Second Amended Complaint. This  
18 demonstrates that further leave to amend would be futile. *Lipton*, 284 F.3d at 1039.  
19 Plaintiffs also fail to explain whether any additional amendment could cure these  
20 deficiencies. The Court therefore dismisses the Second Amended Complaint with  
21 prejudice and without leave to amend.

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23 <sup>16</sup> Plaintiffs’ Section 20(a) claim fails with the Section 10(b) claim. *See Lipton*, 284 F.3d at 1035 n.15.

1 **Conclusion**

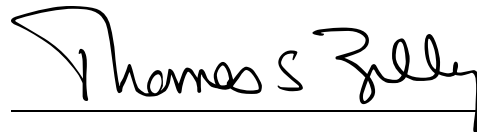
2 For the foregoing reasons, the Court ORDERS:

3 (1) Defendants' Motion to Dismiss, docket no. 44, is GRANTED. Plaintiffs'  
4 Second Amended Complaint is DISMISSED with prejudice.

5 (2) The Clerk is directed to send a copy of this Order to all counsel of record,  
6 enter a judgment consistent with this Order, and CLOSE the case.

7 IT IS SO ORDERED.

8 Dated this 19th day of August, 2020.

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11 Thomas S. Zilly  
12 United States District Judge  
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